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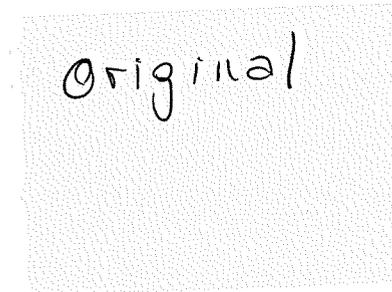
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PUBLIC SERVICE
COMMISSION

VIA OVERNIGHT MAIL

January 27, 2006

Ms. Elizabeth O'Donnell
Executive Director,
Kentucky Public Service Commission
211 Sower Boulevard
P.O. Box 615
Frankfort, Kentucky 40602-0615



Re: An Adjustment of the Gas Rates of The Union Light Heat and Power Company
Case No. 2005-00042

Dear Ms. O'Donnell:

Enclosed please find an original and twelve (12) copies of the Memorandum in Opposition to the Attorney General's Petition for Rehearing in the above-referenced case.

Please date-stamp the extra copies of the Memorandum and return to me in the envelope provided.

Should you have any questions, please contact me at (513) 287-3601.

Sincerely,


John J. Finnigan, Jr.
Senior Counsel

Enclosures

cc: Elizabeth Blackford

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS)	
RATES OF THE UNION LIGHT,)	CASE NO. 2005-00042
HEAT AND POWER COMPANY)	

**MEMORANDUM OF
THE UNION LIGHT, HEAT AND POWER COMPANY
IN OPPOSITION TO
ATTORNEY GENERAL'S PETITION FOR REHEARING**

The Attorney General's Petition for Rehearing claims that the Commission's December 22, 2005 Order approving new retail gas base rates for The Union Light, Heat and Power Company ("ULH&P") is unjust and unreasonable because the Commission: (1) approved rate recovery of a portion of ULH&P's incentive compensation expense; and (2) approved future recovery of a return on investment for ULH&P's new main replacement expense under KRS 278.509. The Attorney General's arguments are not well-taken; therefore, the Commission should deny the Attorney General's Petition for Rehearing.

I. LEGAL STANDARD

A party seeking rehearing of a Commission Order must prove by "clear and satisfactory evidence" that the Order is unreasonable or unlawful.¹ KRS 278.430. A party can establish that a Commission Order is unreasonable only by showing that the

¹ KRS 278.430.

evidence solely supports that party's position and leaves no room for difference of opinion among reasonable minds.² The burden of proof is one of clear and convincing evidence.³ A party can establish that a Commission Order is unlawful by proving that the Order exceeds the Commission's jurisdiction or is confiscatory.⁴

II. INCENTIVE COMPENSATION EXPENSE

The Attorney General argues that the Commission should vacate its Order granting partial rate recovery of ULH&P's incentive compensation expense because this ruling is inconsistent with prior Commission rulings and because the Commission's ruling places greater weight on shareholder interests than ratepayer interests.⁵ Both of the Attorney General's contentions are incorrect.

The evidence well supports the Commission's decision, and the Commission has allowed rate recovery of incentive compensation in certain prior rulings. In fact, the Attorney General's current position (no rate recovery of incentive compensation expense) is the exact opposite of the Attorney General's position in recent Kentucky-American Water rate cases, where the Attorney General argued in favor of sharing of incentive compensation expense between shareholders and customers.⁶

In the present case, ULH&P initially sought recovery of 100% of its incentive compensation expense for the forecasted test period, amounting to \$656,697. The Attorney General recommended eliminating incentive compensation expense from

² *Kentucky Industrial Customers, Inc. v. Kentucky Utilities Co.*, 983 S.W.2d 493 (Ky. 1998).

³ *Public Service Com. v. Continental Tel. Co.*, 692 S.W.2d 794 (Ky. 1985).

⁴ *Commonwealth ex rel. Stephens v. South Cent. Bell Tel. Co.*, 545 S.W.2d 927 (Ky. 1976).

⁵ Attorney General's Petition for Rehearing at 1.

⁶ At hearing, Mr. Henkes, the Attorney General's incentive compensation witness in this case, testified that he supported rate recovery of incentive compensation costs in the 1997 and 2000 Kentucky-American Water Company rate cases, and the Commission approved recovery. The Attorney General also recommended sharing of incentive compensation costs between shareholders and customers in the 2005 Kentucky-American Water Company case. Hearing Transcript at 168-170 (August 15, 2005).

ULH&P's operating expenses because the performance goals for these incentive compensation plans weigh more heavily toward the Company's shareholders' interests than customers' interests, and because the Commission excluded these expenses in the Company's last general gas rate case.⁷

ULH&P presented evidence about its incentive plans from Mr. Timothy J. Verhagen, the Vice President Human Resources for Cinergy Services, Inc. Mr. Verhagen testified that ULH&P's incentive compensation plans allow employees to receive incentive pay if they meet certain performance goals. Some performance goals are based on financial metrics such as total shareholder return or net income. Other performance goals are based on operational metrics such as reliability of customer service and customer satisfaction levels.⁸

ULH&P also presented evidence about its incentive compensation plans from Mr. Robert C. Lesuer, a Principal in the Performance, Measurement and Rewards practice section of Mercer Human Resource Consulting. Mr. Lesuer generally testified that ULH&P's incentive compensation plans are within industry standards; that incentive plans have been demonstrated to improve employee productivity; that ULH&P would not be able to hire and retain talented employees if it discontinued such plans; and that customers would also pay higher costs in the form of increased hiring and training expenses.⁹

In rebuttal testimony, ULH&P proposed to share this incentive compensation expense between ULH&P's shareholders and customers because the incentive plans' performance goals benefit both groups. Accordingly, ULH&P proposed to allocate the

⁷ Henkes Direct Testimony at 35-39.

⁸ Verhagen Rebuttal Testimony at 4-6.

plans' performance goals between shareholder benefits and customer benefits, and would only recover the portion of this expense related to customer benefits.¹⁰ For the performance goals based on net income or total shareholder return, ULH&P proposed to allocate the incentive compensation expense 50/50% between shareholders and customers, because these performance goals benefit both groups. For example, higher net income benefits customers because it reflects operational efficiencies, which allows ULH&P to remain a low cost gas provider.¹¹ Higher earnings improve Cinergy Corp.'s balance sheet, which enables ULH&P to obtain financing on reasonable terms, and to delay future requests for rate increases.¹²

ULH&P proposed to allocate individual and operational performance goals 100% to customers, because these performance goals directly benefit customers. These goals are tied to metrics such as outage frequency, time required to restore service, lost-time accidents, customer satisfaction scores, operation and maintenance expense levels and capital expenditures; therefore, a high performance on these goals will directly result in better and more reasonably priced service.¹³

The Commission rejected ULH&P's proposal to allocate to customers any of the incentive compensation expense based on financial metrics; however, the Commission accepted ULH&P's proposal to allocate to customers 100% of the incentive compensation expense related to individual and operational performance metrics. Based

⁹ Lesuer Rebuttal Testimony at 3-10.

¹⁰ Verhagen Rebuttal Testimony at 3.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 5.

on this ruling, the Commission reduced ULH&P's incentive compensation expense by \$294,290.¹⁴

ULH&P submits the Commission's ruling is just and reasonable because the Commission only requires customers to pay for the portion of ULH&P's incentive compensation expense which directly benefits customers. The Commission's ruling supports ULH&P's effort to structure some portion of employee compensation as incentive pay. This creates incentives for employees to perform at a higher level. Better employee performance enables ULH&P to provide more reliable service and higher levels of customer satisfaction. The Attorney General has totally failed to prove, by clear and convincing evidence, that the Commission's ruling is unreasonable. The Commission should therefore reject the Attorney General's request for rehearing on this issue.

III. RETURN ON INVESTMENT UNDER KRS 278.509

A. Lack of Ripeness

The Attorney General also requests rehearing on the Commission's decision to allow ULH&P to earn a return on investment under KRS 278.509 for ULH&P's future main replacement investment. The Commission should reject the Attorney General's request for rehearing on this issue because this issue is not yet ripe for decision or appeal.

ULH&P's rate increase is based on a forecasted test year for the twelve months ending September 30, 2006. The Commission also approved continuation of Rider AMRP, which allows ULH&P to recover its main replacement cost through an annual tracking mechanism. Under the Commission's ruling, ULH&P will file its next application for recovery of Rider AMRP costs in March 2008, and this application will

¹⁴ Order at 40 (December 22, 2005).
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cover ULH&P's main replacement costs from October 1, 2006 through December 31, 2007. ULH&P will not recover the costs of such future main replacement until the Commission rules on that application. Although the Commission's December 22, 2005 Order states that ULH&P can earn a return on investment for such future main replacement, this issue actually is not ripe for decision or appeal until the Commission grants ULH&P a return on investment in such future case. Accordingly, the Commission should deny the Attorney General's Petition for Rehearing on this issue because the issue is not yet ripe for decision or appeal.

The doctrine of ripeness means that the Commission or a court must be faced with an actual legal controversy where a party's rights are impacted before the Commission or court can make a decision. The purpose of this doctrine is to promote judicial economy by limiting appeals to cases where a party's rights are actually affected. This avoids wasting time deciding issues that are presented in hypothetical situations, where a party's legal rights are not actually affected. The Kentucky Supreme Court has explained this doctrine as follows:

An actual controversy requires that a controversy be ripe for adjudication. Further, the ripeness doctrine requires the judiciary to refrain from giving advisory opinions on hypothetical issues.¹⁵

The Attorney General made a similar lack of ripeness argument in his appeals to the Franklin Circuit Court of the Commission's prior decisions relating to Rider AMRP. The Commission originally approved Rider AMRP in ULH&P's prior gas rate case, but did not approve recovery of any actual costs until ULH&P filed its first application for cost recovery under Rider AMRP, approximately one year later. When the Franklin

¹⁵ *Associated Indus. of Kentucky, v. Commonwealth*, 912 S.W.2d 947, 951 (Ky. 1995).

Circuit Court issued a show cause order to dismiss these appeals for lack of prosecution, the Attorney General explained that he did not pursue the appeal in the gas rate case itself, but waited until appealing the first Rider AMRP order, because he wanted “to avoid piecemeal litigation.”¹⁶ The Attorney General further stated:

The tariff established in this case did not operate to collect any revenues. Instead, it was a concept tariff that would be amended in subsequent separate proceedings to establish the amount of that year’s revenue to be recovered under the tariff for the duration of the three year pilot program.¹⁷

The Commission should reject the Attorney General’s Petition for Rehearing on this issue because the Attorney General has made a similar lack of ripeness argument in the Franklin Circuit Court appeals.

B. The Commission Can Authorize a Return on Investment under KRS 278.509

If the Commission concludes that this issue is ripe for decision in the present case, the Commission should reject the Attorney General’s request for rehearing on this issue because the Commission is authorized to approve recovery of a return on investment under KRS 278.509.

The Attorney General argues that Commission is not authorized to allow a return on investment under KRS 278.509 because the statute states that “the Commission may allow recovery of costs for investment in natural gas pipeline replacement programs” and does not expressly state that the Commission can allow recovery of a return on investment in addition to recovery of costs. The Attorney General contrasts this with KRS 278.183, the environmental surcharge statute, which specifically defines “costs” to

¹⁶ *Commonwealth v. Pub. Serv. Comm’n*, Civil Action No. 02-CI-00499 (Answer to Notice to Dismiss for Lack of Prosecution at 1) (October 24, 2005).

¹⁷ *Id.*

include a return on investment. The Attorney General supports his argument with *Smith v. Wedding*, where the Kentucky Court of Appeals invoked a standard rule of statutory construction that the mention of certain particular items in a list must be construed to exclude other particular items which are not mentioned.

The Attorney General's argument has no merit. KRS 278.509 authorizes the Commission to allow a utility to recover its "costs" for gas main replacement, but does not define the components of these costs. The Attorney General's statutory construction argument therefore does not apply because, unlike the environmental surcharge statute, this statute does not identify particular components of costs which may or may not be recovered. By authorizing the Commission to approve recovery of a utility's costs for gas main replacement, KRS 278.509 authorizes the Commission to approve a return on such investment because it is well-recognized that the cost of capital is a component of the utility's costs.¹⁸ If the Commission approved recovery of a utility's out-of-pocket gas main replacement costs without including recovery of the cost of capital, then the Commission would be acting in a confiscatory manner and this would violate the utility's due process rights.¹⁹

¹⁸ *In The Matter of an Investigation into Butler County Water System, Inc.'s Rate Schedule for Services With Private Fire Protection Facilities*, Case No. 2002-00040 (Opinion and Order) (March 25, 2005).

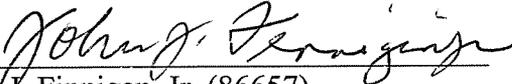
¹⁹ *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

IV. CONCLUSION

Based on the foregoing, ULH&P respectfully requests that the Commission deny the Attorney General's Petition for Rehearing.

Respectfully submitted,

THE UNION LIGHT, HEAT AND POWER
COMPANY



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CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing Memorandum of The Union Light, Heat and Power Company in Opposition to Attorney General's Petition for Rehearing has been served by overnight mail to the following parties on this 30th day of January, 2006.

Hon. Elizabeth E. Blackford
Office of AG
Utility Intervention and Rate Division
1024 Capital Center Drive
Frankfort, Kentucky 40601



John J. Finnigan, Jr.